

1031 EXCHANGES UTILIZING DELAWARE STATUTORY TRUSTS

By T. Craig Lewis III, CPA, CFP®

Many CPAs have clients who own real estate whose value has increased substantially over the past few years. Some of these real estate owners have contemplated selling their properties to take advantage of these extraordinary, inflationary prices. However, many property owners have a very low tax cost basis in their property and are reluctant to sell due to the large capital gains tax they would have to pay Uncle Sam and Louisiana.

The Tax-Advantaged Solution

A tax law provision known as a Section 1031 Exchange allows a real estate owner who holds property for business or investment purposes to exchange their property for other "Like-Kind" property and **defer paying any tax** on the Exchange. The use of the word "Exchange" is somewhat confusing. In most 1031 Exchange transactions, it is actually a sale of the owner's property followed at a later date by the purchase of another property, using a Qualified Intermediary. You can Exchange (sell) any investment or business real estate and Exchange (purchase) any other type of business or investment real estate. They don't have to be the same type of property. An example would be timberland property exchanged for some type of income producing rental property such as a multi-family apartment complex, a self-storage property, or even a mineral royalty interest, etc. These properties could be acquired and professionally managed inside a Delaware Statutory Trust (DST). The DST is created by billion-dollar real estate Sponsors and management companies. A DST permits **fractional ownership** where multiple investors can share ownership in a single property or a portfolio of properties, which qualifies as replacement property as part of an investor's 1031 Exchange transaction. A major advantage of purchasing a DST interest is there are **no management responsibilities for the investor**.

What is a Delaware Statutory Trust?

A DST is a separate legal entity formed as a trust under Delaware law. If properly structured, the DST will be classified as a grantor trust for federal income tax purposes and, as a result, the purchaser of a beneficial interest in the trust will acquire an undivided interest in the asset(s) held by the DST. An investor can use a benefi-

HYPOTHETICAL COMPARISON	SELL	EXCHANGE
Sales Price	\$1,200,000	\$1,200,000
Tax Liability	\$280,000	\$0
Net Proceeds for Reinvestment	\$920,000	\$1,200,000
Total cash Flow for 10 years - 5% annual distribution	\$460,000	\$600,000
Value of the Investment at the end of 10 years - 3% annual growth	\$1,236,000	\$1,612,000
TOTAL Cash Flow and Future Value	\$1,696,000	\$2,212,000

cial interest in a DST as replacement property in a 1031 tax deferred exchange. The IRS issued the **Revenue Ruling 2004-86** that set forth parameters a DST must meet in order to be viewed as a grantor trust and qualify for a viable tax deferring vehicle. Tax reporting for a DST is done on a Schedule E utilizing property operating information provided by the Sponsor.

Why Exchange? A Case Study

The benefit of a Section 1031 tax deferred exchange can be substantial. Let's look at a hypothetical example, where Jane and Tom Smith, both age 70, have decided to sell their 400-acre tract of rural land. A Purchaser has made a very attractive \$1,200,000 offer for the Smith's property.

The Smiths have asked an investment professional whose firm specializes in evaluating and acquiring DST investment offerings to research and present them with available replacement property choices. The Smiths have decided to purchase a fractional DST interest in a 96% occupied, 200-unit luxury apartment complex, built in 2020. They could have also chosen to purchase multiple fractional interest investments in several different types of DST properties for diversification purposes. The Smiths could have also utilized a partial 1031 exchange, and chosen to receive part cash, which would be taxable.

Let's compare The Smiths selling their property and paying federal and state taxes to selling their property and utilizing a 1031 tax deferred exchange into the above hypothetical DST investment.



T. Craig Lewis III, CPA, CFP®, helps clients acquire 1031 DST Replacement Properties, and other Tax Advantaged investments. He is an Investment Professional with over 35 years experience. He does not provide individual tax advice or tax preparation services. Securities are offered through DAI Securities, LLC. Craig resides in Shreveport, LA, and can be reached at craiglewis@lewisfinancialgroup.com, or call 318.797.0447 with any questions. He is a member of LCPA's Estate & Financial Planning Committee

Hypothetical Assumptions

- Tax Cost Basis \$200,000
- 28% Tax Rate (Fed 20% + 3.8%; State 4.25%)
- 5% Annual Cash Flow is Spent
- 3% Annual Compound Growth of Net Proceeds is in addition to Cash Flow
- Reinvestment is in the Same DST for an "Apples-to-Apples Comparison"

The Bottom Line

- The total cash flow and future value of their investment at the end of 10 years was \$516,000 greater.
- The Smith's children and/or grandchildren will inherit a professionally managed, income producing real estate investment with a step-up in date of death value for tax cost basis purposes at the time of the Smiths' deaths. Therefore, the \$280,000 of original deferred tax was completely avoided, and never had to be paid, even when the sales proceeds are received by the children and/or grandchildren. This assumes the Smiths continued to utilize a 1031 exchange for subsequent property sales and purchases while they were living.

The undeniable numbers tell the story of the substantial monetary benefits achieved by utilizing a 1031 tax deferred exchange versus selling and paying taxes. It is very important to keep in mind that there are other rules and deadlines that need to be closely followed to qualify sales and purchase transactions as a valid 1031 Exchange.